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COMMISSION OF THE EUROPEAN COMMUNITIES

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accompanying the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Credit Rating Agencies

SUMMARY OF THE IMPACT ASSESSMENT

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1. INTRODUCTION

Credit rating agencies (CRAs) issue creditworthiness opinions that help overcome the information asymmetry between those issuing debt instruments and those investing in these instruments. CRAs have a major impact on the financial markets, with their rating actions closely followed by investors, issuers, borrowers and governments. It is essential, therefore, that they consistently provide top-quality, independent, and objective credit ratings.

Since August 2007 financial markets worldwide have suffered a major crisis of confidence. This crisis is a complex phenomenon involving multiple actors. CRAs alone cannot be blamed for the current financial turmoil; other actors and special circumstances were implicated. The crisis originated in the US residential subprime mortgage market and subsequently spread into other sectors of the financial markets. CRAs were close to the origin of the problems with subprime markets: they were issuing excessively favourable opinions on structured instruments that were financially engineered to give high confidence to investors. This Impact Assessment considers what would be the most appropriate policy response to the problems identified.

The Impact Assessment presents a number of options for addressing the situation at EU level. The Commission is proposing a series of measures targeting conflicts of interest, the transparency of CRA activities and specific quality aspects of the rating process. These measures would need to be underpinned by a registration and surveillance system for CRAs operating in the EU, to be introduced under EU legislation.

2. PROCEDURAL ISSUES AND PUBLIC CONSULTATION

Against the background of the financial scandals in the US and the EU at the beginning of this century and following the resolution on CRAs adopted by the European Parliament in February 2004¹, the Commission considered very carefully whether or not fresh legislation was required to regulate the activities of CRAs. In line with the advice received from the Committee of European Securities Regulators (CESR) in March 2005², the Commission decided not to present new proposals on CRAs, taking the view that the existing financial services directives applicable to CRAs provided an answer to all the major issues of concern raised by the European Parliament.

Credit rating agencies are subject to various financial services directives, notably the Market Abuse³ and Capital Requirements Directives; they are also subject, on a voluntary basis, to the International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals for credit rating agencies. In 2006 the European Commission issued a communication *Credit Rating Agencies*⁴, in which it concluded that this approach would require it to monitor developments in this area. The Commission also asked the Committee of

¹ European Parliament resolution on the role and methods of rating agencies (2003/2081(INI)).

² CESR technical advice to the European Commission on possible measures concerning credit rating agencies, CESR/05/139b, March 2005. The CESR is an independent advisory group to the European Commission composed by the national supervisors of the EU securities markets, set up in June 2001.

³ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (OJ L 96, 12.4.2003, p. 16).

⁴ OJ C 59, 11.3.2006, p. 2.

European Securities Regulators to monitor compliance with the IOSCO Code and report back on an annual basis.

The Commission indicated that it might consider proposing legislation if it became clear that compliance with EU rules or IOSCO's code was unsatisfactory or if new circumstances arose — including serious market failure problems or significant changes in the way CRAs are regulated in other parts of the world.

In view of the recent events in the financial markets, the Commission asked the CESR and the European Securities Markets Expert Group (ESME)⁵ in autumn 2007 to provide advice on various aspects of CRAs' activity and role in the financial markets and especially in structured finance. The Commission followed the work of both groups throughout the entire process. Both groups widely consulted stakeholders notably on the role of structured finance in the subprime turmoil. The CESR reported on 13 May 2008 and ESME on 4 June 2008.

As well as closely following the progress of work at CESR and ESME, the Commission held discussions with major rating agencies and other stakeholders (industry associations from the insurance, securities and banking sectors, information providers, etc.). It also received written inputs from a wide range of associations, market practitioners and stakeholders. On the international side, it closely followed other international developments such as the revision of the code of conduct for CRAs approved by IOSCO on May 26, the report of the Financial Stability Forum (FSF)⁶ published on 7 April 2008 and the proposals for changes in the US Act on CRAs presented on 11 June and 1 July 2008. The Commission also followed the consultations carried out by both IOSCO and the FSF. It took into consideration the various initiatives proposed and/or implemented by the CRAs either individually or on an industry-wide basis and benefited from intensive informal dialogue with rating agencies. It also encouraged comments from interested stakeholders in a public consultation starting on 31 July 2008, receiving 82 contributions: 13 from credit rating agencies, 52 from stakeholder organisations (banks, associations, investment funds, savings banks, etc.) and 17 from securities regulators and national finance ministries.

3. PROBLEM DEFINITION

Evidence shows that CRAs have performed markedly worse in assigning ratings to innovative, structured products than in issuing traditional ratings. The Commission's analysis therefore focuses on the issues that have arisen from rating structured finance products. However, it has to be borne in mind that as financial innovation progresses, similar problems may occur in the future in other areas where credit rating agencies have little or no experience. Moreover, certain deficiencies apparent in structured finance ratings relate to the structure, business model and internal processes of the entities, i.e. may also affect the more traditional areas of CRA activity.

⁵ The European Securities Markets Experts Group (ESME) is an advisory body to the Commission composed of securities markets practitioners and experts. It was set up in April 2006.

⁶ The Financial Stability Forum was convened in April 1999 and brings together on a regular basis national authorities responsible for financial stability in significant financial centres, international financial institutions, sector-specific groupings of regulators and supervisors, and committees of central bank experts.

3.1. Failures in the integrity of CRAs; conflicts of interest in the rating business

All contributors, institutions and stakeholders consulted unanimously expressed the view that potential conflicts of interest when CRAs rate structured products have not been avoided or managed satisfactorily.

3.2. Lack of quality in methodology and ratings

The significant number of downgrades observed in the second half of 2007 and first quarter of this year as compared to the first half of 2007 clearly indicates that the ratings given before the start of the turmoil were overoptimistic and failed to reflect market conditions in the underlying assets. One cause of this poor performance is most probably the lack of quality in the methodologies used by the CRAs to issue a rating.

3.3. Lack of transparency in CRAs' activity

CRAs do not communicate the characteristics and limitations of ratings for structured finance products with sufficient precision, nor do they provide sufficient information on critical model assumptions. This lack of information hinders market participants' understanding of the ratings' significance. CRAs deliver information on rating performance, but this information does not facilitate comparison of CRAs' performance.

4. OBJECTIVES

To deal with the problems defined above, three specific objectives need to be translated into substantive requirements.

- (1) Ensure that CRAs manage any conflict of interest appropriately.
- (2) Ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings.
- (3) Increase the transparency of CRAs.

There is also a broader, overriding objective, which is to enhance the compliance of CRAs throughout the European Union with the measures taken to remedy the problems identified.

5. POLICY OPTIONS

In view of the above objectives, a number of alternative options were analysed.

5.1. Policy options for substantive requirements

5.1.1. 'Ensure that CRAs manage any conflict of interest appropriately'

A number of issues need to be tackled.

1. General approach to dealing with conflicts of interest.
2. Conflicts of interest triggered by CRAs' advisory activity.

3. Dialogue between rating analysts and the rated entity.
4. Independence of the people involved in the rating process.
5. 'Shopping for ratings'.
6. Analysts joining the issuers they have rated.

5.1.2. *'Ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings'*

A number of issues need to be tackled.

1. Quality of methodologies, models and key rating assumptions.
2. Rating surveillance.
3. Impact of methodology changes.
4. Quality of information used in ratings.
5. Staffing issues.
6. Impact of market developments and macro economic expectations.

5.1.3. *'Increase the transparency of credit rating agencies'*

A number of issues need to be tackled.

1. The transparency of internal processes and procedures.
2. Ratings content.
3. Differentiating ratings for structured finance.
4. CRA performance statistics.

5.2. Instruments to put the policy options in place

As regards the overarching objective of enhancing CRAs' compliance throughout the European Union with the measures taken to remedy the problems identified, the following options are examined.

Option 1: Self-regulation, including:

- (a) the IOSCO Code of Conduct;

- (b) The ‘industry White Paper’ — it would be assumed that the agencies themselves would find appropriate solutions to the problems and concerns cited above⁷;
- (c) Additional initiatives by individual CRAs — several CRAs presented regulators and the market with a series of proposed improvements and committed themselves individually to incorporating them in their internal practices and procedures.

Option 2: A European Code of conduct for CRAs by which members of the industry would commit themselves to maintain a series of voluntary standards and to accept and follow the recommendations of a monitoring body that would check signatories’ compliance with the code.

Option 3: Commission Recommendation setting out the standards that CRAs would have to comply with to operate in the EU — the same standards as in option 4 (legislation). The standards would build on the revised IOSCO code and CESR and ESME recommendations and would include additional standards considered essential by the Commission.

Option 4: EU legislation providing for a comprehensive regulatory framework covering all existing (and prospective) CRAs with business operations in Europe whose ratings are used for regulatory purposes such as the Capital Requirements Directive⁸. The proposal would lay down conditions for the issuance of credit ratings, introducing a registration procedure and an external surveillance regime by EU regulators.

6. ANALYSIS OF IMPACTS

Given the technical character and detail of the policy options addressing objectives 1 to 3, their particular impacts are not summarised here, but are set out in the Report. Here, we only analyse the various means of enforcement.

Self-regulation

The IOSCO Code fails to meet the policy objectives: CRAs’ management of conflicts of interest would remain as it is now, thus inappropriate; CRAs would not be obliged to improve their rating methodology and rating quality; the transparency of CRAs would not be increased; and there would be no supervision and enforcement mechanism for competent authorities. The Industry White Paper and other initiatives are very flexible for CRAs as they would be free to adapt to new voluntary requirements. However, they would not be effective since they do not envisage a strong mechanism to monitor compliance with the standards set. Moreover, no common framework would be guaranteed. Self-regulation has been tested since 2006 and the outcome is far from acceptable.

⁷ In January 2008 the five main CRAs jointly addressed a White Paper to regulators with 12 proposals to improve the IOSCO code of conduct in relation to the independence, quality and transparency of credit ratings.

⁸ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

A European code of conduct

This solution would be highly flexible, because CRAs would be able to apply the ‘comply or explain’ principle. It has the advantage of including a monitoring body, albeit without any enforcement power so its effectiveness would be limited. It would ensure a reliable common framework, although no significant legal certainty could be achieved. The outcome would not be sufficient to satisfy the policy objectives.

A Recommendation by the European Commission

This solution would help establish, to some extent, a common framework, at least concerning the reference criteria that CRAs had to fulfil; however, it could not include an enforcement mechanism and thus would have limited effectiveness in achieving the policy objectives.

Legislation

This solution would ensure a level playing field within the Community for all market players, instead of a fragmented legal regime for CRAs throughout 27 Member States, which could arise if the EU does not act but keeps the current self-regulatory regime based on the IOSCO Code. A legislative proposal would include a ‘diligent supervision’ system and a robust enforcement mechanism and thus be effective in assuring compliance with the policy objectives. It would ensure that the framework proposed for the issuance of credit ratings would be duly implemented, diligently supervised and robustly enforced.

7. COMPARING THE OPTIONS — CONCLUSIONS

After due consideration of the impacts of all specific policy options and their advantages and disadvantages compared with the baseline scenario, the following conclusions may be drawn.

To meet Objective 1 (Ensure that CRAs manage appropriately any conflict of interest), CRAs will have to ensure that all existing and potential conflicts of interests are identified and either eliminated or properly managed and disclosed. Specific internal governance arrangements will need to be put in place to assist changes to corporate culture and internal policies. CRAs will be prohibited from providing consultancy or advisory services. Rating analysts will need to be insulated from the commercial aspects of the CRAs’ activities and to be subject to more demanding rules regarding dialogue with the client. Before analysts are employed in a position by a former client, specific safeguard rules should apply. Finally, CRAs’ clients should be discouraged from harmful ‘shopping for ratings’.

To meet Objective 2 (Ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings), CRAs will have to use methodologies that are rigorous, systematic, continuous, and can be validated based on historical experience. Methodologies, models and key ratings assumptions will need to be kept up-to-date and subject to comprehensive, regular review. An internal review function will be established to monitor compliance in this area. Changes to rating methodologies will trigger prompt re-rating of all existing ratings concerned. CRAs will also have to monitor and update individual ratings on an ongoing basis. Greater transparency will be required to help users of ratings understand the due diligence conducted on the asset-level data and factored into the ratings. CRAs will need to disclose staff levels to trigger closer market scrutiny.

To meet Objective 3 (Increase the transparency of CRAs) a general transparency obligation needs to be imposed on CRAs regarding the functioning of their internal processes and procedures, coupled with a duty to publish a yearly transparency report. Information on analyses performed, any limitations and specific risks involved will need to be provided to users of ratings. CRAs should also use different rating categories for structured and traditional debt or provide investors with additional information when rating structured finance products. Historical performance statistics will need to be prepared using metrics that ensure comparability between market players.

The legislation will set up a registration procedure for CRAs to ensure that their credit ratings can be used by credit institutions, investment firms, insurance and assurance undertakings, collective investment schemes and pension funds within the Community. Efficient and effective monitoring of compliance with the requirements will be ensured throughout the EU (**overarching objective**). The registration will be carried out by the competent authority of a Member State, but all Member States' regulators should be able to express their opinion through the CESR. Day-to-day supervision will be carried out by the competent authorities of the Member States. Close cooperation between national regulators and coordination by the CESR is a prerequisite to creating a common supervisory culture and an efficient network approach. National regulators should be empowered to act and apply efficient sanctions where CRAs do not comply with the rules. Again, the CESR should play an important role in creating a common enforcement culture.